

**DISTRICT OF COLUMBIA**

**WATER AND SEWER AUTHORITY**

# Board of Directors

DC Retail Water and Sewer Rates Committee

## Tuesday, June 9, 2016

9:30 a.m.

MEETING MINUTES

**Committee Members in Attendance**

Rachna Butani, Acting Chairperson

Matthew Brown, Board Chair

Obiora “Bo” Menkiti

Ellen Boardman (via conference call)

Howard Gibbs

Reverend Kenrick Curry

Ana Harvey

**DC Water Staff**

George Hawkins, General Manager

Mark Kim, Chief Financial Officer

Henderson Brown, General Counsel

Linda Manley, Board Secretary

Syed Khalil, Manager Financial Planning

**Call to Order**

Acting Chairperson Butani called the DC Retail Water and Sewer Rates Committee meeting to order at 9:30 a.m.

**FY 2017 & FY 2018 Rate Proposal (Attachment A)**

Mr. Kim provided an overview of the agenda for the FY2017 and FY2018 rate proposal. He then began the presentation by reviewing DC Water’s operating reserve fund requirements, which are established by the Master Indenture and Board policy. The Master Indenture requires that DC Water maintain 60 days equivalent of operations and maintenance (O&M) expenses in its operating reserve fund. This is a legal requirement and must be maintained. If DC Water falls below the 60 days equivalent of O&M, the Authority will have breached its bond covenants and will trigger a default on its bonds. The Authority currently has approximately $2.7 billion in bonds outstanding.

The Board has established a policy of maintaining the greater of 120 days of O&M or $125.5 million in the operating reserve fund. Currently, the $125.5 million is the greater of the two and serves as the Authority’s current operating reserve fund requirement. In order to maintain the $125.5 million operating reserve fund requirement, management has set a target of maintaining a minimum balance of $140 million in total (cash) reserves. In response to several questions, Mr. Kim explained that the $140 million target balance is necessary to provide a cash cushion for normal day-to-day fluctuations between expenditures versus revenues, particularly given the size of our capital program and that certain months may see expenditure outflows totaling $60 million or even $70 million. Revenues are generally more even and predictable, with retail inflows coming in monthly and wholesale (plus Federal) inflows coming in quarterly. Ms. Boardman inquired if DC Water’s operating reserve fund balance has ever fallen below the $125.5 million requirement, and if so, how many times? Mr. Kim replied that the Authority has come very close to falling below the $125.5 million requirement several times over the past couple of years, but the $140 million target balance has provided the necessary cushion to absorb negative cash flow while maintaining the $125.5 million reserve requirement. Mr. Kim highlighted a table in the presentation which summarized the Authority’s operating reserve fund requirements:

* DC Water’s operating reserve fund requirements are established by our Master Indenture and Board policy
  + Indenture requirement of maintaining 60 days O&M
  + Board policy of maintaining 120 days O&M or $125.5 million
* Management targets maintaining a minimum of $140 million in the operating reserve in order to satisfy Board policy

In FY2015, Mr. Kim informed the committee members that the Authority’s ending operating reserve fund balance totaled approximately $160 million, or about $20 million above management’s target balance of $140.0 million. Mr. Kim explained that management made a recommendation to the Finance & Budget Committee that the Authority maintain this additional amount in cash and to carry it over to FY2016 to offset any potential contingencies in FY2016 budget, including on-going performance testing of the Digesters and uncertainty related to the expired collective bargaining agreement.

Reverend Curry inquired about the financial results from operations in FY2013 and FY2014. Mr. Kim replied that he would be returning to this exact question later in the presentation in the context of establishing the Authority’s historical cash surplus and recommended uses. Reverend Curry then asked how much excess liquidity (cash surplus) DC Water needs and how is it used? Mr. Kim replied the $125.5 million requirement is established by Board policy and is the absolute minimum cash balance that must be maintained at all times. Mr. Kim stated that any amount above management’s target balance of $140 million would be considered excess liquidity or cash surplus. Moreover, Mr. Kim added that management provides the Finance & Budget Committee with year-end projections and recommendations regarding any cash surplus, which are restricted by the Authority’s Financial Policy for contributions to the Rate Stabilization Fund (RSF), transfers to Pay-Go, or to hold in cash and carry over to the next fiscal year.

Mr. Gibbs asked Mr. Kim to summarize the various Master Indenture requirements? Mr. Kim responded that Master Indenture establishes several operating reserve fund requirements, including the Renewal and Replacement Fund (R&R Fund) which is required to be maintained at $35 million. The Master Indenture also establishes an Operating Reserve Fund which is required to be maintained at the equivalent of 60 days O&M and includes any balance in the R&R Fund. The “Undesignated Reserve Fund” balance is the additional cash that is required in order to meet the Board-established operating reserve fund policy of $125.5 million. Mr. Kim reiterated that management targets maintaining a balance of $140 million in total operating reserve funds and that any amounts above that level would be considered excess liquidity or cash surplus. Reverend Curry asked how the excess liquidity or cash surplus is used? Mr. Kim responded that all operating reserve funds are held in cash or cash equivalents, and that these funds provide the Authority with additional liquidity to handle contingencies.

Mr. Hawkins added that the excess liquidity is used to make sure that the Authority does not fall below the $125.5 million requirement and that each year management will make a recommendation to the Finance & Budget Committee if any excess liquidity is projected. Mr. Hawkins continued that any excess liquidity would be used to either fund the Rate Stabilization Fund (RSF) to lower future required rate increases or for Pay-Go to fund capital expenditures with cash rather than debt.

Mr. Kim then moved to a review of the Authority’s debt service coverage ratio requirements. He informed the Committee that the Authority’s ability to pay its debt is the single most important metric the rating agencies use to evaluate DC Water’s creditworthiness. DC Water’s debt service coverage ratios are used to insure that the Authority is able to maintain solvency and sufficient liquidity to achieve its financial targets. The Master Indenture establishes legal rate covenants that require DC Water to maintain 1.2x coverage on our senior debt and 1.0x coverage on our subordinate debt.

Mr. Kim explained that the Master Indenture establishes a “flow of funds” and restricts every dollar of revenue that DC Water earns with the following “priority of payment”: 1) O&M expenses; 2) senior lien debt service; 3) subordinate lien debt service; 4) replenishment of reserve fund balances; and 5) any excess to the Authority’s general fund. The priority of payment means that, after O&M expenses, the Authority’s senior lien bond holders will receive payment first and that the subordinate lien bond holders will receive payment second. The debt service coverage ratios mean that for every $1.00 of senior lien debt service, the Authority needs $1.20 of free flow cash after O&M, and that for every $1.00 of subordinate lien debt service after all the senior lien debt service is paid, the Authority need $1.00 of free flow cash.

Mr. Kim further explained that the Board has established a debt service coverage ratio policy that exceeds the legally mandated coverage for a minimum of 1.4x on senior lien debt service and 1.2x combined coverage of senior and subordinate debt. In other words, after O&M expenses are paid, Board policy dictates that for every $1.00 of senior lien debt service, the Authority must generate $1.40 of excess free flow cash. On a combined debt service coverage basis, for example, if we have $100 of total debt service in a given year we need $120 of free flow cash after O&M.

Mr. Kim then explained that management has established a combined debt service coverage ratio of 1.5x in order to maintain the Board’s policies and DC Water’s credit ratings. The reason why credit ratings are essential to DC Water is that they directly impact the cost of capital. Every time the Authority attempts to access the capital markets to pay for its Capital Improvement Program (CIP), the interest rate on the bonds will depend on DC Water’s credit ratings. The 1.5x coverage ratio is truly one of the most important metrics that management uses to develop its financial plan.

Mr. Kim referred to the table in the presentation summarizing DC Water’s projected debt coverages ratios. For FY2016-FY2018, DC Water is projected is maintain its 1.5x coverage ratio. In FY2016, DC Water projects to spend approximately $160 million on total debt service. Accordingly, in order to meet the 1.5x coverage ratio, the Authority must generate $80 million of “surplus” revenue. Given that the $80 million is actually a requirement, the “surplus” revenue is not really surplus in the common usage of the term because if the Authority does not generate that additional revenue, it would fail to meet Board policy and Indenture requirements. Mr. Kim characterized the surplus as “net revenue” and stated that the Authority’s financial plan incorporates that net revenue as Pay-Go for the following fiscal year. In response to several questions from the Committee members, Mr. Kim stated that DC Water would almost certainly be downgraded if it did not maintain management’s 1.5x combined debt service coverage ratio target. Reverend Curry asked Mr. Kim if the Board policies are adequate to meet the rating agency requirements to maintain a certain level of cash flow. Mr. Kim reiterated that if DC Water were to lower its actual debt service coverage ratios to the Board policy levels of 1.2x combined, then the Authority would be downgraded.

Acting Chairperson Butani inquired about the types of information DC Water conveys to the rating agencies about our coverage ratios. Mr. Kim replied that the rating agencies are aware of DC Water’s legal requirements as established by its Master Indenture, as well as the Board’s financial policies and management’s performance targets. The rating agencies give the most weight to the Indenture requirements, followed by Board policies and hold DC Water accountable to achieve its stated management targets. One of the most important elements of maintaining our credit ratings is to establish a certain level of trust and a track record of performance. Management has done this by clearly communicating its performance goals and being able to execute and deliver on its financial plan. In addition, the rating agencies have highlighted the strength of DC Water’s Board and governance structure both in terms of financial oversight and approving required rate increases to meet its financial obligations.

Mr. Gibbs asked about how the numbers were calculated for the projected debt service coverage ratios. Mr. Kim replied that those ratios are based on our ten-year financial plan, which includes projected O&M expenditures, capital disbursements and debt service. These figures are taken together with projected revenues to arrive at the projected debt service coverage ratios. Mr. Brown and Reverend Curry noted how difficult it is to make accurate projections over a 10-year period.

Acting Chairperson Butani inquired how DC Water decides what type of debt to issue in the future. Mr. Kim stated that it is both a strategic and tactical decision and depends on market conditions and investor demand at the time of structuring the debt, as well as making sure that we have a balanced debt portfolio and are able to meet all coverage ratio requirements. For example, even if it was more advantageous to issue senior debt from an interest rate perspective, there may be more capacity to issue subordinate debt from a coverage ratio perspective. There is a balance that management strives to maintain between market-based factors and debt management policies and practices when deciding what type of debt to issue. Acting Chairperson Butani asked if there are policies regarding the issuance of senior or subordinate debt. Mr. Kim replied we do not have policies that strictly limit the percentage or amount of debt that we issue, beyond those established by our Master Indenture, and that it is management’s responsibility to maintain an appropriate balance.

Mr. Gibbs asked about the difference between senior debt and subordinate debt. Mr. Kim replied that the most important difference between senior debt and junior debt is the priority of payment. In practical terms, if DC Water had $1.00 in revenue after paying O&M and $1.00 of senior lien debt service and $1.00 of subordinate lien debt service, then the holders of the senior debt would get paid fully and the holders of the subordinate bonds would not get paid. Accordingly, since the holders of subordinate debt are taking more risk, it typically costs DC Water more to issue subordinate debt. In other words, DC Water has to pay a higher interest rate to issue subordinate debt because we are asking those investors to take on more risk by standing lower in the priority of payment. In the current interest rate environment, however, there is almost no difference in cost for DC Water to issue senior debt or subordinate debt. As a result, DC Water has been issuing predominantly subordinate debt to take advantage of market conditions.

Mr. Gibbs inquired what the rationale might be for issuing all senior or subordinate debt in a more “normal” interest rate environment. Mr. Kim replied that there is no reason why DC Water could not do that subject to meeting all Indenture requirements and Board policies. However, DC Water’s senior lien debt represents the lowest cost of capital for the Authority so it is prudent to be conservative with its use and perhaps strategically issue more during higher interest rate environments. So, right now in the current environment when interest rates are so low, DC Water would be wise to save its senior debt capacity for a rainy day. If and when the Fed finally starts raising rates in a sustained manner and it becomes more expensive for DC Water to issue subordinate debt relative to senior debt, then it may make more sense to issue senior debt with more frequency.

Reverend Curry returned to the financial plan and asked if the projected numbers are included in the model. Mr. Kim confirmed that the projections are included in the model, and Reverend Curry asked whether it was possible to change the amount of senior debt and subordinate debt yet still arrive at the targeted 1.5x coverage ratio. Mr. Kim responded that the financial plan includes certain assumptions about the issuance of senior and subordinate debt, as well as future interest rates, in order to project our future coverage ratios and that it would certainly be possible to change those assumptions and still meet our targets. For example, if the financial plan had assumed the issuance of senior debt in FY2018 but it was more advantageous to issue subordinate debt, then we would adjust our financial plan accordingly. Reverend Curry asked how frequently DC Water compares the projected values against the actual values to see if the model holds and what correlation is derived. Mr. Kim replied that the correlation between predicted performance and actual performance is very strong. DC Water’s revenue projections are typically +/- 1% of the model’s projections. The expenditure projections are more volatile, usually within +/- 5% to 10% of the model’s projections.

Mr. Menkiti inquired whether there should be any concern that certain Board policies are actually out of line with management’s strategy in terms of the difference between the debt service coverage ratios. Mr. Kim replied that management routinely reviews Board policies with its financial advisors on an annual basis and stated that the Board policies are strong and consistent with DC Water’s high credit ratings. Although the Board could change those policies to more closely align them with management’s targets, Mr. Kim stated that the value of changing the Board policies for an incremental alignment is not worth the effort that would be needed to explain why the policies were changed when the financial targets were being achieved. Mr. Kim then highlighted a table in the presentation which summarized the Authority’s debt service coverage ratio requirements:

* Indenture rate covenant requires 1.2x senior and 1.0x subordinate debt service coverage
* Board policies exceed Indenture-required coverage ratios
  + Minimum 1.4x senior lien debt service coverage
  + Minimum 1.2x combined coverage of senior and subordinate debt
* Management targets a combined debt service coverage ratio of 1.5x and rating agencies expect DC Water to sustain this level of cash flow in order to maintain our credit ratings

Mr. Kim turned to a review of the Rate Stabilization Fund (RSF). DC Water’s Board established the RSF by Resolution in 1997. The RSF is not legally required by the Master Indenture, and it is entirely at the Board’s discretion to deploy any funds held in the RSF. The RSF is the primary tool that the Board has to manage one-time required water and sewer rate increases. The purpose of the RSF is not a substitute for ongoing cash flow or required revenue. The RSF is most prudently used for one-time, non-recurring expenditures, such as if your roof falls in and you need to dip into your rainy day fund to pay for it. The RSF is not meant to cover an ongoing cash flow shortfall or to substitute for revenue needed to pay for O&M expenses.

Ms. Boardman asked whether DC Water had used the RSF to stabilize rate increases and to pay one-off expenses rather than O&M. Mr. Kim responded in the affirmative and noted that DC Water has historically used the RSF to manage “spikes” in required rate increases. The best use of the RSF would be to strategically and tactically “buy down” a spike in rates in order to keep rate increases closer to a historic average. Used in this way, the RSF would mitigate “rate shock” and allow rate increases that are more gradual and less volatile. This is how most well-run utilities use their RSF.

Ms. Boardman asked whether the RSF balance is used to satisfy the operating reserve fund balance requirement or if it is embedded within any other reserve balance. Mr. Kim responded that the RSF balance is not used to satisfy the operating reserve fund requirements and is maintained in addition to any operating reserves. Acting Chairperson Butani asked how many other authorities use a RSF. Mr. Kim replied that it is very common in the industry and that it is considered a standard tool Boards like to have at their disposal. Mr. Kim noted that in the absence of an RSF, DC Water would have no choice but to pass on the full brunt of a required rate increase to its customers each year.

Mr. Hawkins highlighted a chart in the presentation illustrating DC Water’s historical and projected RSF balances and explained the buildup of the RSF to help mitigate DC Water’s most recent and dramatic increase in capital spending. Acting Chairperson Butani asked how much pressure the RSF places on the two-year rate setting proposal. Mr. Kim responded there are pros and cons. The primary benefit of a multi-year rate proposal is greater certainty with respect to revenues. The potential risk is that while DC Water’s revenues are now “locked-in” its expenditures remain contingent, requiring greater budget discipline and cost control. This risk creates more pressure to make sure that there are sufficient funds in the RSF to mitigate potential rate spikes. Acting Chairperson Butani asked if the two-year rate proposal put more pressure on staff to manage tighter operating and capital budgets. Mr. Hawkins replied in the affirmative.

Mr. Kim informed the Committee that from FY2008 – FY2015, DC Water had withdrawn over $114 million from the RSF in order to mitigate required rate increases to fund a rapid expansion in the Authority’s capital program during this time. No RSF withdrawals are currently projected in the current 10-year financial plan covering the period FY2016 – FY2025. Mr. Kim further noted that in FY2009 – FY2015, DC Water spent $3.1 billion on capital investments that was largely financed with debt and paid for with increased rates. DC Water was embarking on major capital programs including a $900 million ENR facility, $500 million Digester facility and approaching peak spending on its $2.6 billion Clean Rivers program. Over the past couple of years, nearly $1.5 billion of new infrastructure assets have been brought in service. DC Water capital spending peaked in FY2014 and is currently ramping down. Mr. Kim stated that withdrawing over $114 million dollars from the RSF during this period was very fiscally prudent and an excellent use of the RSF. Unfortunately, the RSF has been depleted and it is now time to replenish it for the next cycle of capital spending.

In FY2016 – FY2025, DC Water’s CIP disbursement budget totals $3.6 billion, with the Clean Rivers program totaling $1.2 billion. Mr. Hawkins mentioned that in January 2016, DC Water modified its consent decree which allows for another five years to finish the Clean Rivers program. Moreover, Mr. Hawkins noted that had DC Water not gotten the 5-year extension, its CIP would likely be significantly higher than it is currently projected to be.

Mr. Brown inquired whether the use of the RSF was restricted to water and sewer rates, CRIAC, or any other use. Mr. Kim referred to Board Resolution #10-76, Revised Rate Stabilization Policy, and quoted that the authorized use and stated purpose of the RSF is to “assist in mitigating annual rate increases.” Mr. Kim further noted that the original policy was adopted in Board Resolution #97-124 and specifically stated that the purpose of the RSF was to “help mitigate rate spikes and allow smoothing of annual rate increases.” Mr. Kim suggested that he would seek further guidance from the Authority’s General Counsel on this question and advise the Committee accordingly. Mr. Brown agreed and asked whether the RSF is governed solely by Board policy and Mr. Kim responded in the affirmative.

Mr. Kim noted that Board policy does not establish a target balance for the RSF. In response to a several questions, Mr. Kim further noted that management has had numerous discussions with its rate consultants and financial advisors about an appropriate target RSF balance for an entity of DC Water’s size and projected capital expenditures and concluded that a $100 million balance in the RSF is an appropriate target RSF balance. DC Water’s RSF has a current balance of approximately $32 million.

Mr. Menkiti inquired about how management was planning to raise the RSF balance to $100 million. Mr. Kim responded that there are no further withdrawals planned or projected during the current 10-year financial plan covering the period FY2016 – FY2025. In addition, Mr. Kim stated that there is projected cash surplus over the next ten years sufficient to reach the target RSF balance of $100 million. Mr. Menkiti asked if management is concerned about its ability to fund the RSF to the target balance. Mr. Kim replied in the affirmative and noted that any contributions to the RSF are dependent on achieving the projected financial results from operations and discretionary decisions that are made by the Board on an annual basis.

Mr. Brown noted that DC Water is planning to contribute $19 million to the RSF this year while raising rates 5% and raised a concern about the absolute level of rate increases over the past several years to finance the expansion of our capital program. Reverend Curry asked Mr. Kim about the percentage of the excess cash that has funded the RSF over time and how that compares to the annual rate increases for DC Water’s customers. Mr. Kim responded that he would return to address this exact question momentarily in his presentation. Mr. Brown then asked that staff from DETS to provide a breakdown of the prioritization of the CIP by major project. Mr. Kim responded that he would request that the Chief Engineer provide this information and follow up accordingly and Mr. Brown agreed.

Acting Chairperson Butani then raised a concern about the impact on rate payers over the absolute level of rate increases to fund the Clean Rivers program and asked staff to consider a number of alternative approaches to balance the amount of RSF replenishment with current relief of the CRIAC. Specifically, Acting Chairperson Butani asked if it would be possible to limit the amount of contributions to the RSF in any given year at a certain level and then to apply the balance towards providing a one-time credit for that year’s CRIAC to provide our customers with rate relief. Mr. Kim responded that staff will “run the numbers” on various alternatives and provide the Committee with its recommendation at the next Rates Committee meeting. Acting Chairperson Butain agreed and suggested that DC Water add a line item on the customer bill showing a credit against the CRIAC.

Mr. Gibbs recognized DC Water staff for doing as much as it has to keep rates as low as possible, but asked if it was possible to do more. Mr. Kim responded “Absolutely!” and proposed adding “CRIAC Affordability” as a high priority action item to the Committee’s Proposed FY2017 Workplan. Mr. Kim committed to providing the Committee with concrete proposals on creative ways to expand DC Water’s affordability programs to include the CRIAC. The Committee was in agreement with this proposal and Reverend Curry noted that with the CRIAC approaching 25% of the average customer bill, staff should also specifically consider the impacts of this charge on affordable housing, non-profit organizations and houses of worship. Mr. Hawkins affirmed that staff would conduct a “deep dive” on the CRIAC and add this action item to the Committee’s Proposed FY2017 Workplan.

Mr. Kim then turned to a review of the CIP and gave an update on the FY2016 CIP disbursement budget.

* For FY2016, total CIP disbursements are projected to be 1.5% under the approved budget of $549 million based upon the first 6 months of the current fiscal year
  + Capital projects are projected to be 2.9% (or $14.5 million) over the approved budget of $499 million
  + Additional capital programs for capital equipment are projected to be $22.9 million under the approved budget of $50.0 million, potentially offsetting higher projected disbursements in capital projects
  + Clean Rivers program does not project any significant variances from its approved budget of $223 million

Mr. Kim reviewed the preliminary FY2017 – FY2016 CIP, which is projected to be $3.75 billion. This figure represents a slight increase over the existing ten-year plan due to the first year of the Clean Rivers program consent decree extension in FY2026. Mr. Kim then described both the preliminary 3-year and 10-year CIP disbursement budgets:

* Preliminary CIP disbursement estimates for FY2017 – FY2026
  + $1.27 billion in FY2017 – FY2019 (three-year disbursement budget)
  + $3.75 billion in FY2017 – FY2026 (ten-year disbursement budget)

Mr. Kim then reviewed the sources of funds for the CIP and explained that nearly 50% of the CIP is projected to be funded by the issuance of debt. In other words, for the current $3.6 billion CIP, DC Water expects to issue approximately $1.8 billion of debt over the next ten years. Pay-Go (i.e., cash) financing of capital is projected to be approximately 27% and reminded the Committee members that the “net revenue” needed to achieve the debt service coverage ratio requirements are earmarked to fund Pay-Go. Mr. Kim noted that Pay-Go and debt financing totals 75% of the sources of funds for the CIP and these costs are entirely borne by DC rate payers. Federal grants and appropriations represent 6% and approximately 18% are capital contributions from the suburban jurisdictions. In response to a question from Mr. Brown, Mr. Kim explained how the newly adopted System Availability Fee (SAF) revenue will be incorporated into the sources of funds for the CIP starting in FY2018. Mr. Brown asked if the projected revenue from the SAF were incorporated into the financial plan and used to offset required rate increases. Mr. Kim answered in the affirmative and noted that the use of SAF revenue was restricted to Pay-Go and that the impact on rates from projected SAF revenue was modest.

Mr. Gibbs asked about the Washington Aqueduct’s CIP and its impact on DC Water’s own CIP. Mr. Kim responded that just as the suburbs are wholesale customers of DC Water and make capital contributions (i.e., cash) towards its CIP, DC Water is a wholesale customer of the Aqueduct and makes capital contributions (i.e., cash) towards its CIP. DC Water is responsible for approximately 75% of the operating and capital expenditures of the Aqueduct and sits on its Board, which approves its operating and capital budgets.

Mr. Gibbs asked how much leverage DC Water has over the size of the Aqueduct’s CIP. Mr. Hawkins replied that DC Water has a tremendous amount of leverage. DC Water currently contributes about $10 million a year for the Aqueduct’s capital program. The actual capital needs maybe different.

Mr. Brown returned to the financial plan and asked Mr. Kim how frequently it is updated and how the budget and rates are factored in the plan. Mr. Kim explained that the financial plan is updated annually and presented to the Board for approval after the close of each fiscal year, usually in tandem with the next proposed operating and capital budgets. Once the actual results from prior fiscal year are incorporated into the financial plan, the assumptions and projections are then updated to model the required rate increases to meet the Authority’s financial targets. Although the financial plan is formally presented to the Board for approval on an annual basis, management regularly updates and revises the plan throughout the year based upon actual results and experience.

Reverend Curry returned to the SAF and inquired about the public comments regarding affordable housing projects like those outlined in the Mayor’s plan and whether DC Water took into consideration the impact on the SAF would have on affordable housing when it set the fee. Mr. Kim confirmed that DC Water spent a significant amount of time taking in consideration the comments received from the public with respect to affordable housing. Further, Mr. Kim noted that the tenor of the comments that DC Water received with respect to affordable housing had more to do with the extended time period that is required to bring this type of project online and that it would have a disproportionate impact on affordable housing development because the initially proposed effective date was too soon. Projects that were already in the pipeline would all of a sudden be subject to the SAF when developers would have already secured project financing. DC Water took these comments into consideration and they were the primary driver in management’s decision to recommend a delay in the SAF effective date to allow all projects that are already in the pipeline to have cleared before the new SAF fee is implemented.

Mr. Kim also noted that there were relatively few comments that spoke to the burden of incorporating the SAF into the overall cost of the project. DC Water is the only utility in the region that does not charge a SAF and its proposed fee is significantly lower than any other fee charged in the region for comparable projects. DC Water took into consideration the magnitude of the fee to make sure that the SAF is in line with and lower than similar fees assessed by other utilities in the region.

Mr. Hawkins mentioned that DC Water will monitor the impact of the SAF on affordable housing and is always willing to reexamine the fee if it is determined that the consequences are unwanted and unfair.

Reverend Curry asked for a review of how the SAF will be implemented. Acting Chairperson Butani referred Reverend Curry to the minutes of the committee meeting when the SAF was extensively discussed and recommended. Mr. Kim responded that once the SAF becomes effective January 1, 2018, any project requesting a permit for new service will be assessed the full SAF fee. Mr. Kim added that there were some exemptions for inactive properties as well as a SAF installment payment plan.

Mr. Gibbs asked if District regulations preclude multiple meters on a single property. Mr. Kim responded that they do not and added that DC Water created two incentive structures with the WSRF and SAF for all customers to right size their meters. Mr. Kim also noted that property owners will be allowed to “neck-down” water lateral lines to smaller meter sizes. In addition, DC Water exempted fire flow from the fee calculation, which is based solely upon peak demand.

Acting Chairperson Butani noted that the SAF recovered actual costs and that if those costs were not being recovered by this fee then they would be charged to all rate payers through their water and sewer rates. She noted further that the express purpose of this fee is to make those who are responsible pay the fee instead of requiring everyone else to pay it for them.

Mr. Kim then turned to a review of the key FY2017 operating budget assumptions and risks. Mr. Kim began by noting that the Authority’s NPDES permit expired 2015 and is currently being renegotiated with the US EPA. While DC Water does not anticipate any new regulatory requirements, the risk remains until negotiations are completed and the operating permit is secured. Given recent events in Flint and the regulatory climate on Capitol Hill, Mr. Kim noted that there is a very real possibility on a national level for mandated work on lead service lines. Wholesale lead service line replacement is not currently budgeted in the current CIP and would put financial pressure on DC Water if it comes to pass. Mr. Hawkins stated that DC Water does have a partial lead service line replacement program budgeted in the CIP and noted that customer requests for partial lead service replacements have increased from $0.5 million to $2.0 million this year.

Mr. Kim stated that DC Water is currently projecting to be over budget on its personnel services costs. The primary drives are lower vacancy rates and higher fringe benefit costs (particularly for health care insurance premiums). In addition, Mr. Kim noted that DC Water’s collective bargaining agreement expired in FY2015 and this will have a potentially large budget impact on the Authority. In terms of non-personnel services (i.e., contractual services), there are a number of contingencies that may adversely impact the FY2017 budget, including new wastewater treatment process facilities and related O&M costs, potential increase in insurance premiums for excess liability and property coverage due to increased asset portfolio, and potential legal claims and litigation expenses.

Mr. Kim continued to describe a number of high important priority initiatives that are not fully funded in FY2017 because DC Water had not completed its evaluation. Anyone of these initiatives may have a significant impact on either the operating or capital budgets: 1) AMR/AMI replacement program; 2) customer information system (Vertex) upgrade or replacement; 3) financial system (Lawson) upgrade or replacement; and 4) capital project management system (Primavera P-6) upgrade or replacement.

Mr. Kim noted that the budget for debt service is conservative by design because DC Water must take into account future interest rates and the types of debt it will issue over the next 10 years (senior versus subordinate, fixed versus floating). DC Water is currently underweight in its debt portfolio in terms of floating rate debt and intends to issue more in the future. The more floating rate debt, the greater the interest rate risk DC Water is exposed to.

Mr. Kim then turned to a review of wastewater treatment (WWT) operations and the digester-related assumptions in the FY2017 budget. Mr. Kim noted that the total expenditure budget for WWT O&M decreased by $6.5 million from the FY 2016 approved budget vs. the FY 2017 approved budget. The key drivers that are related to the digester include savings related to chemicals, electricity and hauling. DC Water’s chemical costs are projected to decrease by $1.8 million, electricity costs are projected to decrease by $5.5 million, and hauling costs are projected to decrease by $1.2 million.

Mr. Kim presented the table below illustrating the FY2013 – FY2015 Historical Net Cash Surplus.



In FY2013, DC Water ended the year with net income of $61.3 million, which included a beginning cash balance of $14.8 million over target and Board-approved transfers of $24.5 million to Pay-GO and $4.1 million to RSF, leaving a net cash surplus of $47.4 million. Management’s recommendations were an additional $3.4 million to RSF, $28.0 million to Pay-Go and hold $16.0 million over target ending cash balance. In FY 2013, total debt service was $107 million which means that DC Water needed about $50 million of excess cash flow in order to meet its combined debt service coverage ratio target of 1.5x.

In FY2014, DC Water had enormous financial challenges in managing both its operating and capital budgets. In the operating budget, DC Water’s collective bargaining agreement had been expired since FY2012 and management reached an agreement with Labor in late FY2014 with retroactive pay provisions which had an enormous adverse financial impact in personnel services costs. In addition, DC Water had budgeted a certain amount of digester-related savings and, unfortunately, the project experienced delays and those O&M savings were not realized in FY2014. In the capital budget, DC Water over-spent its CIP by over $100 million, which meant that DC Water had to issue $100 million more in debt than it was budgeting for in order to cover the shortfall. As a result, net income in FY2014 decreased to $41.1 million and net cash surplus decreased to $19 million. DC Water transferred $1.3 million to Pay-Go and held $17.6 million over target ending cash balance. In FY2014, total debt service was $120 million which means that DC Water needed about $60 million of net income versus the $41 million in net income it generated to meet its combined debt service coverage ratio targets.

In FY 2015, DC Water had a very large rate increase to accommodate the shortfall in FY2014. As a result, DC Water financial condition improved and ended the year with $83.9 million in net income and $59.8 million in net cash surplus. Management’s recommendations were an additional $17.5 million to RSF, $22.3 million to Pay-Go and hold $20.1 million over target ending cash balance. In FY 2015, total debt service was $140 million which means that DC Water needed about $70 million of excess cash flow to meet its combined debt service coverage ratio of 1.5x. The three figures in the chart for CFCI of $20.1 million, transfer to CIP (pay-go) of $41.7 million and the additional transfer to Pay-Go of $22.2 million total $84 million, which helped to make up for the prior year’s shortfall.

Mr. Kim then turned to a review of the current year FY2016 Projected Net Cash Surplus. DC Water is projecting to be about $1.4 million short on revenue versus the Board approved budget.



The lower receipts are due to (a) partial billing of WSRF for the month of October 2015, (b) time lag for collections, which follow billings by a month and (c) non-receipt of WSRF for Federal government since the 2016 Federal Bill, prepared in April 2014, did not include estimates for WSRF. The FY2016 WSRF will be trued-up in the FY2019 Federal Bill, so DC Water will ultimately receive this revenue.

Mr. Kim described the purpose of the Cash Finance Capital Improvements (CFCI) line item in the expenditure budget as a “down payment” on Pay-Go to meet the debt service coverage ratio targets. Mr. Gibbs asked if CFCI only part of the target 1.5x debt service coverage ratio, why DC Water does not budget the full amount. Mr. Kim noted that managements targets CFCI funding to be approximately equal to 5% of revenue. While this figure does not equate precisely to the entire amount of the target 1.5x debt service coverage ratio, this was a huge step forward for more transparent budgeting at DC Water.

Returning to the FY2016 projections, Mr. Kim stated that DC Water is projecting net income of $71.5 million and a net cash surplus of $13.4 million after Board approved transfers for Pay-Go and RSF. Mr. Kim noted that the projected net cash surplus for FY2016 will have a modest impact on rates if used to make an additional transfer to the RSF or for Pay-Go:

* A 1% reduction in retail water and sewer rates would equate to approximately a $3 million annual reduction in operating income or a $30 million revenue loss over the 10-year financial plan
* Accordingly, if used to make an additional transfer to the RSF for use in FY2017, the projected net cash surplus of approximately $13.4 million would equate to a one-time reduction in the proposed rate by 0.45% (or from 5.0% to 4.55% for FY2017) to account for lost revenue over the next 10-year period while holding future rate increases at current projected levels
* Alternatively, a 1% reduction in retail water and sewer rates would equate to an approximately $40 million reduction in debt issuance capacity on a one-time basis
* Accordingly, if used to make an additional transfer for Pay-Go for use in FY2017, the projected net cash surplus of approximately $13.4 million would equate to a one-time reduction in the proposed rate by 0.33% (or from 5.0% to 4.66% for FY2017)

As a result, Mr. Kim stated that management intends to recommend to the Finance & Budget Committee holding the projected net cash surplus as additional cash over the target ending balance in order to provide added operational flexibility to address the previously discussed contingencies in the FY2017 budget.

Mr. Brown pointed out that the 10-year financial plan is a long period to look at a $13.4 million surplus. By comparison, the District makes these types of determinations over a 4 year period. Mr. Brown noted that the 10-year financial plan is good practice and that he is happy that DC Water is able to do it but reiterated that it is a very long plan and each year the assumptions becomes cloudier in the outer years.

Mr. Kim presented the proposed FY 2017 & FY 2018 Rates for the Committee’s consideration:

* Board approved a new multi-year rate proposal for public notice and comment covering both FY 2017 and FY 2018, providing added revenue certainty and reducing volatility in financial projections
* Management initially recommended a 5% increase in the retail water and sewer rates in each of FY2017 and FY2018, which already represented a decrease from the prior year’s approved financial plan projections of 6.5% in FY2017 and 6.0% in FY2018
* In consideration of both the projected net cash surplus in FY2016 and significant operational uncertainties in the FY2017 budget, management is revising its rate proposal to recommend a **4.75% increase in FY2017 and a 5% increase in FY2018** together with its recommendation to hold any net cash surplus as additional cash over the target ending balance in FY2016

Mr. Brown asked about the impact of the 4.75% increase versus the original 5.0% increase for FY2017. Mr. Kim replied that the decrease would have a very modest benefit, with the average residential customer savings about $1 per year. There was discussion amongst the Committee members and general consensus that the proposed decrease would provide very limited relief to our ratepayers and that using the projected net cash surplus to provide a one-time credit for the CRIAC in FY2017 was a preferred approach over decreasing the rate to 4.75%. Consequently, Acting Chairperson Butani requested the Committee members to hold off on approving the rate proposal for FY2017 & FY2018 until its next Committee meeting on June 28 to fully consider the information provided and to allow staff to consider the Committee’s suggestion to maintain the original rate proposal of 5% together with an additional contribution to the RSF from the projected net cash surplus to provide a one-time credit in FY2017 for the CRIAC.

Mr. Hawkins suggested the following two-step process: 1) staff will fully consider the suggestions made today and make a recommendation on the projected net cash surplus to the Finance & Budget Committee on June 23rd and then 2) staff will make a recommendation on the rate proposal for FY2017 and FY2018 to the DC Retail Water and Sewer Rates Committee on June 28th. Acting Chairperson Butani agreed together with the other Committee members and the meeting was adjourned.

**Adjournment**

The meeting was adjourned at 12:20 p.m.

**FOLLOW-UP ITEMS – DC Retail Water and Sewer Rates Committee Meeting (June 9, 2016)**

1. Permitted uses of the RSF. (Ms. Butani) Status: June 2016
2. CIP prioritization by major project. (Mr. Brown) Status: June 2016
3. CRIAC credit in FY2017. (Ms. Butani) Status: June 2016
4. CRIAC affordability in general and focus on affordable housing, non-profits and religious organizations in particular. (Ms. Butani and Reverend Curry) Status: FY 2017 Workplan